

Report on
2003 Limited Inspection
of Ernst & Young LLP

Issued by the
Public Company Accounting Oversight Board

August 26, 2004

THIS IS A PUBLIC VERSION OF A PCAOB INSPECTION REPORT

**PORTIONS OF THE COMPLETE REPORT ARE OMITTED
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SECTIONS 104(g)(2) AND 105(b)(5)(A)
OF THE SARBANES-OXLEY ACT OF 2002**

Notes Concerning this Report

1. Portions of this report may describe deficiencies or potential deficiencies in the systems, policies, procedures, practices, or conduct of the firm that is the subject of this report. The express inclusion of certain deficiencies and potential deficiencies, however, should not be construed to support any negative inference that any other aspect of the firm's systems, policies, procedures, practices, or conduct is approved or condoned by the Board or judged by the Board to comply with laws, rules, and professional standards.
2. Any references in this report to violations or potential violations of law, rules, or professional standards should be understood in the regulatory supervisory context in which this report was prepared. Discussions of the Board's or Board staff's views on such matters are not a result of an adversarial adjudicative process and do not constitute conclusive findings of fact or of violations for purposes of imposing legal liability. Similarly, any description herein of a firm's cooperation in addressing issues constructively should not be construed, and is not construed by the Board, as an admission, for purposes of potential legal liability, of any violation.
3. In connection with inspections of registered public accounting firms, the Board and its staff consider whether the firm, in its audits of financial statements, has failed to identify departures from Generally Accepted Accounting Principles (GAAP). This report's descriptions of such failures necessarily involve descriptions of the Board and Board staff's view of the relevant GAAP departures. The Board, however, has no authority to prescribe the form or content of an issuer's financial statements. That authority, and the authority to make binding determinations concerning an issuer's compliance with GAAP, rests with the Securities and Exchange Commission ("SEC" or "Commission"). The description, in this report, of perceived departures from GAAP should not be understood as an indication that the Commission has considered or made any determination regarding these GAAP issues unless otherwise expressly stated.
4. The audit engagements reviewed during this limited inspection concerned financial statements for periods that ended before the relevant standards (then referred to as Generally Accepted Auditing Standards or "GAAS") were adopted by the PCAOB on an interim basis as the PCAOB standards that, under the Act, now govern the audits of the financial statements of issuers. For consistency with other Board actions related to PCAOB standards, this inspection report refers to the applicable standards as PCAOB standards even with respect to periods before the Board adopted the standards. *Cf.* Auditing Standard No. 1 – References in Auditors' Reports to the Standards of the Public Company Accounting Oversight Board, PCAOB Release No. 2003-025 (Dec. 17, 2003) (approved by the Commission, May 14, 2004).

INSPECTION REPORT OVERVIEW

In 2003, the Public Company Accounting Oversight Board conducted inspections of public accounting firms for the first time. The Board inaugurated its inspection program with limited inspections of the four largest U.S. public accounting firms, including Ernst & Young LLP, the subject of this report. In those inspections, the Board identified significant audit and accounting issues that were missed by the firms, and identified concerns about significant aspects of each firm's quality controls systems. The Board's inspection reports describe those issues. Because Board inspections and inspection reports are new, however, the Board offers a few remarks by way of providing readers with a context for the observations described in this report.

The Board's statutorily prescribed mission is to oversee auditors of public companies in order to protect the interests of investors and to further the public interest in the preparation of informative, fair, and independent audit reports. To advance that mission, Board inspections take up the basic task that had been the province of the accounting profession's peer review system, but Board inspections do not duplicate the programs and approach of peer review.

Board inspections do, of course, examine technical compliance with professional accounting and auditing standards, but Board inspections also examine the business context in which audits are performed, and the ways in which that context influences firm audit practices. Among other things, the Board looks at firm culture, the relationships between a firm's audit practice and its other practices, and the relationship between a firm's national office and its engagement personnel in field and affiliate offices. Through this approach, the Board believes that it can help bring about constructive change in the types of practices that contributed to the most serious financial reporting and auditing failures of the last few years.

Toward that end, an essential ingredient of the Board inspection process is an unflinching candor with firms about the points on which we see a need for improvement. That emphasis may often result in inspection reports that appear to be laden with criticism of a firm's policies, practices, and audit performance, and less concerned with a recitation of a firm's strengths. That is because, from the Board's perspective, the inspection reports are not intended to serve as balanced report cards, rating tools, or potential marketing aids for any firm. The reports are intended principally to focus our inspection-related dialogue with a firm on those areas where improvement is either required for compliance with relevant standards and rules, or is likely to enhance the quality of the firm's audit practice.

The reports' emphasis on these criticisms, however, should not be understood to reflect any broad negative assessment. The four firms inspected in 2003 are made up of thousands of audit professionals, have developed multiple volumes of quality control policies, and perform audits for a combined total of more than 10,000 public companies. It would be a mistake to construe the Board's 2003 inspection findings as suggesting that any of these firms is incapable of providing high quality audit services.

Moreover, the Board does not doubt that the bulk of the firms' audit professionals consists of skillful and dedicated accountants who strive – at times against the competing priorities of the large and complex business of the firms – to make audit quality their top priority. The Board is encouraged by the increasing tendency of persons at the highest levels of the firms to speak of the need for a renewed commitment to audit quality as the firm's top priority. The Board is also encouraged by the firms' recognition of the value of the Board's inspection process. The Board will continue to use its inspection authority to focus the firms on aspects of their practice that may stand as an impediment to the highest quality audit performance.

PCAOB Release No. 104-2004-003

2003 LIMITED INSPECTION OF ERNST & YOUNG LLP

In 2003, the Public Company Accounting Oversight Board ("PCAOB" or "Board") conducted a limited inspection of Ernst & Young LLP ("E&Y"). The Board is today issuing this report of that inspection in accordance with the requirements of the Sarbanes-Oxley Act of 2002 ("the Act").

The Board is making portions of the report publicly available. Specifically, the Board is releasing to the public Part I of the report and portions of Part III of the report. Part III of the report consists of the firm's comments on a draft of the report.^{1/}

The Board has elsewhere described in detail its approach to making inspection-related information publicly available consistent with legal restrictions.^{2/} A substantial portion of the Board's criticisms of a firm (specifically criticisms of the firm's quality control system), and the Board's dialogue with the firm about those criticisms, occurs out of public view, unless the firm fails to make progress to the Board's satisfaction in addressing those criticisms. In addition, the Board generally does not disclose otherwise nonpublic information, learned through inspections, about the firm or its clients. Accordingly, information in those categories generally does not appear in the publicly available portion of an inspection report.

^{1/} The Board does not make public any of a firm's comments that address a nonpublic portion of the report. In addition, pursuant to section 104(f) of the Act, 15 U.S.C. § 7214(f), and PCAOB Rule 4007(b), if a firm requests, and the Board grants, confidential treatment for any of the firm's comments on a draft report, the Board does not include those comments in the final report at all. The Board notes that it routinely grants confidential treatment, if requested, for any of a firm's comments that the firm reasonably believes are mooted by a change in the report.

^{2/} See Statement Concerning the Issuance of Inspection Reports, PCAOB Release No. 104-2004-001 (August 26, 2004).

PART I

INSPECTION PROCEDURES AND CERTAIN OBSERVATIONS

Members of the Board's Inspection staff ("the staff") performed a limited inspection of E&Y during the period from June 2003 through December 2003. The staff performed field work at E&Y's national office and at five of its practice offices. The staff also observed and tested aspects of E&Y's internal inspection program at one additional practice office.

The limited inspection included a review of certain portions of selected audit engagements and a review of policies and procedures in the following seven functional areas, which were selected based on criteria identified by the Board:

- Tone at the top;
- Practices for partner evaluation, compensation, promotion, and assignment of responsibility;
- Independence implications of non-audit services; business ventures, alliances and arrangements; and commissions and contingent fees;
- Client acceptance and retention;
- The firm's internal inspection program;
- Practices for establishment and communication of audit policies, procedures and methodologies, including training; and
- The supervision by U.S. audit engagement teams of the work performed by foreign affiliates on foreign operations of U.S. audit clients.

Part I.A below provides a description of the steps that the staff took with respect to the review of audit engagements and the review of the seven functional areas. Following that, Part I.B describes, at a general level, certain observations concerning E&Y's audit performance as observed in the review of audit engagements. The public portion of this report then concludes with certain general observations in Part I.C.

A. The Inspection Process

The staff carried out extensive procedures related to E&Y's public company audit practice. Even so, the Board emphasizes the limited nature of this initial inspection of E&Y compared to the scope of the inspections that the Board intend to conduct for large firms as going forward. Although the practical considerations in creating a new inspection program (including the time required to enlist a sufficient number of appropriately skilled staff) prevented the Board from conducting full-scale inspections in 2003, the Board determined that conducting limited inspections was feasible and would advance the public interest by providing a foundation for the full-scale inspections to come.

1. Review of Selected Audit Engagements

At the outset of the inspection, the staff selected 16 audit engagements to review. The staff chose the engagements according to the Board's own criteria. As with any Board inspection, E&Y was not allowed an opportunity to limit or to influence the selection process.

For these engagement reviews, the staff selected certain subject matters for review, such as: revenues, reserves or estimated liabilities, related party transactions, supervision of work performed by foreign affiliates, the assessment of risk by the audit team, and journal entries and adjustments. The staff also analyzed potential adjustments to the issuer client's financial statements that had been identified during the audit but not recorded in the financial statements. While at the practice offices, the staff also interviewed, by phone, the chairs of the audit committees of 15 of the issuers whose audits the staff reviewed, and reviewed communications between the firm and the audit committee.

When the staff identified a potential issue, the staff spoke with members of the audit engagement team. If the staff was unable to resolve the issue through this discussion and any resultant review of additional work papers or other documentation, the staff ordinarily requested the engagement team to consult with the Professional Practice Director for the relevant regional area^{3/} ("Area PPD"). Area PPDs are audit partners who do not serve individual clients, but serve as resources within the firm for technical accounting and auditing consultations. In many cases, the engagement team's consultation with the Area PPD resulted in resolution of the matter, either because E&Y agreed with the position the staff had taken and the firm or the issuer took adequate steps, in light of the significance of the error, to remedy the exception, or because E&Y

^{3/} E&Y is organized into 13 regional areas in the United States.

was able to provide additional information that effectively addressed the staff's concerns.

2. Review of Seven Functional Areas

The staff conducted the procedures related to the review of these areas primarily at E&Y's national offices, but while at the four practice offices originally selected, the staff also performed procedures relating to six of the functional areas listed above.^{4/} At the national office, the staff interviewed numerous members of the firm's leadership; read and evaluated extensive documentation of firm policies and procedures; analyzed other source documents relating to the functional areas inspected; and reviewed communications from the national office to firm personnel.

At the practice offices, the staff interviewed Area management, when appropriate, and office leadership, partners and managers and reviewed relevant documentation. The staff also conducted focus group sessions of staff, outside the presence of office leadership and on a not-for-attribution basis. The Board staff conducted separate group sessions for audit senior managers or managers and for lower-level audit staff. In these groups, the Board staff facilitated discussion by the participants of their understanding of the messages conveyed by firm and office leadership and other personnel, and how these messages might affect the participants' actions. The review of the seven functional areas will be used to provide a knowledge base upon which to draw in planning inspections, comparing firm practices, and measuring and evaluating progress by, or deterioration of, E&Y over time.

Naturally, each of the functional areas reviewed involved a scope of materials and procedures particular to it. A more detailed description of the scope with respect to each of the seven functional areas is set out below.

a. *Review of Tone at the Top*

The primary objective of the review of the firm's "tone at the top" was to assess whether actions and communications by the firm's leadership demonstrate a commitment to audit quality and compliance with the Sarbanes-Oxley Act, the rules of the Board, the rules of the SEC, and professional standards in connection with the firm's performance of audits, issuance of audit

^{4/} The functional area not specifically reviewed at the practice offices is the establishment and communication of audit policies, procedures and methodologies, including training.

reports, and related matters involving issuers. Toward that end, the staff read, reviewed and analyzed the following information at the national office:

- The firm's code of conduct;
- Documentation related to the E&Y ethics hotlines;
- Organizational charts, descriptions of the duties of the board and biographies of governing board members (Americas Executive Board and the Partner Advisory Council);
- A description of the reporting relationship of E&Y's top technical partner to its CEO;
- Ten public company audit proposals;
- The most recent client and audit committee survey used to evaluate client managements' or audit committees' satisfaction with services provided by the firm;
- The "client service model," which includes a summary of the roles and responsibilities of each engagement team member;
- Policies and procedures for evaluation of partner performance, partner compensation, nomination and admission of new partners, assignment of duties, termination and reassignment, and measures used by management for monitoring partner activities;
- Policies and procedures for the monitoring of audit quality for individual engagements and partners;
- The most recent policies and procedures for accepting prospective public company clients and continuance of existing public company clients;
- The strategic business plans for the firm, for each major service line of the firm; for each geographic area, and for national and specialty practices;
- Documentation showing the financing structure of the firm;
- Selected industry and/or product programs;

- Internal publications and internal communications, including communications from management and area or local office internal communications;
- Presentations and speeches by senior firm leadership;
- The agendas and minutes of meetings of the management committees, the Americas Executive Board, and the Partner Advisory Council.

In addition, the staff interviewed 26 members of the firm's leadership team.

The staff also performed procedures at each of the four practice offices. The staff interviewed the practice office leadership, including Area managing partners (where appropriate), AABS^{5/} managing partners, Area PPDs, and selected audit business and professional leaders. In addition, the staff interviewed several audit partners and senior managers or managers on the 16 engagements reviewed to obtain their perspectives on messages and communications from the firm's leadership related to audit quality and the tone at the top.

At each of the four practice offices, the staff also conducted two separate focus group meetings with six to 10 audit senior managers or managers and six to 10 audit senior accountants. The purpose of the focus group meetings was to assess the participants' understanding of, among other things, the messages conveyed by firm leadership, office leadership and their supervisors, and how such messages might affect their actions on audits, as well as to hear their perspectives on the tone at the top.

b. Review of Partner Evaluation, Compensation, Promotion, and Assignment of Responsibility

The objectives of the inspection procedures in this area were to assess the firm's current policies and procedures for evaluating partner performance and determining partner compensation; to determine the relative weight the firm gives to marketing of services as opposed to audit quality and technical competence in admitting new partners, measuring partner performance, establishing partner compensation, assigning responsibilities to partners, and disciplining partners; and to evaluate whether the design of the measurement, evaluation and

^{5/} The Assurance and Advisory Business Services ("AABS") includes the audit line of service for the firm.

compensation processes as documented and communicated could be expected to achieve the objective of promoting audit quality. Toward those ends, the staff read, reviewed and analyzed the firm's policies and procedures related to the following:

- Evaluation of partner performance;
- Determination of partner compensation;
- Process for nomination and admission of new partners; and
- Assignment of duties, and termination or re-assignment of partners.

The staff also –

- Reviewed schedules and supporting documents that included each partner's name, office location, assigned management responsibilities (other than engagement responsibilities), years as a partner, overall partner evaluation, age, amount of the prior year's income allocation, and other information;
- Reviewed a schedule of personnel considered for partnership admission but not admitted in the current year;
- Selected a sample of 39 partners and reviewed each partner's personnel file and the documentation therein of the factors used by the firm in establishing the partner's compensation;
- Selected a sample of 25 newly admitted partners, 25 direct partner admissions, and five individuals who were considered for admission to the partnership, but were not admitted, and reviewed the stated rationale for the decision to admit or not admit;
- Selected a sample of 25 partners who resigned, were terminated or took early retirement during the year and reviewed the stated rationale for the action;
- Interviewed members of the Americas Executive Board, Chairman and CEO, Vice Chair of Quality and Risk Management, Vice Chair – People (human resources), Vice Chair – Partnership Accounting and Administration, CFO, COO, major service line leaders, and the firm's top technical partner (Vice Chair – AABS Risk Management

and Professional Practices) in order to understand the process of compensating partners.

The staff's procedures at the four practice offices included:

- Interviews with the partner in charge of an issuer client engagement and, in certain circumstances, one other partner assigned to that engagement to determine how partners allocate their time during the year (e.g., to performing audits, to maintaining client relationships, to sales or marketing activities, or to training, coaching and recruiting personnel); the effects partner compensation policies have on that allocation; and the relative effects the partners believe audit quality, selling, and technical competence have on their compensation, evaluation, and advancement within the partner ranks. Furthermore, the staff reviewed personnel files of these partners to determine whether their prior evaluations support their assignment to the audit engagements being inspected; and
- Interviews with Area leadership, including the Area managing partner, AABS managing partner, and Area PPDs, regarding the new partner admission process, the performance of the engagement partners the staff interviewed, and that of any senior managers who were considered for admission but were not admitted, and any disciplinary actions taken.

c. Review of Independence Policies

The objectives of the inspection procedures in this area included gaining an understanding of certain E&Y policies and procedures relating to the firm's compliance with independence requirements. In particular, the staff focused on independence issues related to the provision of non-audit services to issuer clients and concerning the firm's business ventures, alliances, and arrangements. The staff also focused on the firm's internal processes for monitoring compliance with those policies. To accomplish these objectives, the staff reviewed the firm's policies, procedural guidance and training materials pertaining to independence matters. The staff –

- Reviewed policies, procedures, guidance materials, and practice aids related to independence (including independence consultations) for non-audit services to audit clients by service line;

- Reviewed a description of the processes for establishing an alliance and making venture capital investments;
- Reviewed a description of the procedures for independence consultations;
- Reviewed materials for training programs on independence;
- Reviewed documentation of E&Y's internal inspection program as it relates to monitoring compliance with E&Y's independence policies and procedures;
- Interviewed numerous national office and practice office personnel;
- Reviewed a list of non-audit services (and related revenue) provided to audit clients and non-audit clients for the 12 months ended June 30, 2003; and
- Reviewed listings of E&Y's known business ventures, alliances, and arrangements, along with a description of the nature and purpose of each.

For each of the 16 engagements reviewed at the four practices offices initially selected for review, the staff reviewed relevant information to identify any non-audit services performed for the issuer, as well as any business ventures, alliances, or arrangements with the issuer; and to determine whether the fees for the services provided are classified appropriately in the issuer's proxy statement. In addition, the staff read and evaluated the most recent letter pursuant to Independence Standards Board ("ISB") Standard No. 1, *Independence Discussions with Audit Committees*.

d. Review of Client Acceptance and Retention Policies

The primary objective of the inspection procedures in this area was to evaluate whether the firm's client acceptance and retention policies and procedures reasonably assure that it is not associated with issuers whose management lacks integrity. A firm should undertake only engagements within its professional competence and should appropriately consider the risks involved in accepting and retaining clients in the particular circumstances. Toward those objectives, the staff read, reviewed and analyzed the following information at the national office:

- Documentation describing accounts designated as focus accounts in the 2003 client continuance process; the client acceptance process for former Arthur Andersen clients in 2002; and the process involved in monitoring auditor changes in Form 8-K filings;
- Policies and procedures for acceptance of prospective audit clients and continuance of existing audit clients, including guidance relating to clients designated by the firm as "close-monitoring" clients because of a significant risk identified by the firm;
- The client acceptance and client continuance databases, and the forms used in the acceptance and continuance processes;
- A list of all issuer audit clients accepted by the firm during the period July 2002 to June 2003, including the practice office to which the client was assigned, the predecessor audit firm, whether the change involved any of the situations described in Item 304(a)(1)(v) of SEC Regulation S-K, and whether the predecessor audit firm was dismissed or resigned;
- A list of all issuer audit clients that had changed from E&Y to other auditors during the period July 2002 to June 2003, and for each such former client, a copy of the Form 8-K and the related SECPS letter; and
- A list of 24 prospective issuer clients rejected during the client acceptance and continuance process.

The staff also –

- Read and evaluated 31 client acceptance packages and nine client retention packages for completion and approval in accordance with firm policies;
- Reviewed the documentation related to five potential issuer clients that ultimately were rejected and five "lost clients" for compliance with the firm's policies and procedures and professional and regulatory requirements;
- Interviewed members of the Americas Executive Board, Chairman and CEO, Vice Chairman Quality and Risk Management, CFO, COO, major service line leaders and the Vice Chairman of Risk

Management and Professional Practices to obtain an understanding of the client acceptance and continuance practices and procedures.

At the four practice offices, the staff –

- Reviewed client acceptance documentation for seven issuer client engagements designated "close-monitoring" and client continuance documentation for 19 issuer client engagements designated close-monitoring, in order to evaluate the approval process, the reasons for acceptance or continuance, and any risk mitigation steps; and
- Reviewed seven issuer client acceptance packages and 19 issuer client retention packages and evaluated whether the documentation was completed and approved in accordance with firm policies.

e. Review of Internal Inspection Program

The objectives of the inspection procedures in this area were to evaluate the effectiveness of the firm's annual internal inspection program in enhancing audit quality, including evaluating the results and the remedial actions taken, and to observe and test the conduct of the internal inspection program in one practice office to assess compliance with the quality control standards adopted by the Board.

The staff read, reviewed and analyzed the following information at the national office:

- Policies and procedures for the internal inspection program, including the program's goals and objectives, and the methods of selection of offices, partners, and engagements to be reviewed;
- The internal inspection engagement questionnaires, engagement information forms used in the selection process, the reviewer profile forms, and a copy of the matter sheet used to document findings by the reviewer;
- Results of the current year's internal inspection program, the reviewers' findings, and the firm's evaluation of the results; and
- Communications of the 2003 internal inspection program results to the firm's senior management and to partners and professional staff.

Further, the staff conducted interviews with the Global Director of Assurance Quality Control, who is the partner in charge of the internal inspection program, and gained an understanding of the program and process. The staff also interviewed members of the Americas Executive Board, Chairman and CEO, Vice Chairman of Quality and Risk Management, CFO, COO, major service line leaders, and the firm's top technical partner (Vice Chairman Risk Management and Professional Practices). In the practice offices, the staff interviewed 24 partners and seven senior managers, including the Area managing partners, AABS managing partners and Area PPD's, as well as selected audit business and professional leaders, regarding the internal inspection program and its effectiveness.

The staff reviewed and tested the conduct of the internal inspection program at one practice office of the firm, and performed the following procedures:

- Reviewed and evaluated the qualifications and experience of the firm's inspectors;
- Reviewed four of the 12 engagements reviewed by the E&Y internal inspectors, including performing the following procedures:
 - Read the issuer's financial statements and the firm's audit report;
 - Read the engagement team's overall summary memorandum;
 - Reviewed the engagement team's work papers for several areas;
 - Read the matter sheets and other documentation of the review that the firm's internal inspectors had prepared;
 - Attended the closing meeting between the engagement team and the firm's internal inspectors; and
 - Compared the staff's findings with those of the firm's internal inspectors, and discussed and followed up with the firm regarding any significant differences;

- Read a summary of the firm's matter sheets for the internal inspection review of the practice office selected;
 - Reviewed the results of the internal inspection team's review of the functional areas (human resources, consultation, and client acceptance and retention);
 - Attended and observed the internal inspection closing conference for the practice office selected;
 - Read and evaluated the firm's inspection reports on the practice office selected; and
 - Evaluated the effectiveness of the firm's inspection program in the practice office selected.
- f. Review of Practices for Establishment and Communication of Audit Policies, Procedures and Methodologies, Including Training*

The objectives of the procedures in this area were to obtain an understanding of the firm's processes for establishing and communicating audit policies, procedures and methodologies, including training; to evaluate whether the design of these processes could be expected to promote audit quality and enhance compliance; to evaluate changes in audit policy the firm has made; and to evaluate the content of the firm's training on the recently issued Statement on Auditing Standards No. 99, *Consideration of Fraud in a Financial Statement Audit* ("SAS 99").

The staff read and analyzed the following information at the national office:

- A memorandum explaining how the firm develops and revises its policies and procedures;
- Lists of the changes made to the firm's electronic database of policy and practice manuals from May 2002 through July 2003;
- Internal guidance distributed to audit personnel for recent changes to accounting and auditing literature and regulatory requirements;
- Excerpts from internal guidance on SAS 99;

- Training materials for 2003 SAS 99 seminars conducted for all U.S. audit partners, managers, and seniors; and
- An information release on responding to allegations by whistleblowers of fraud and ethics violations.

The staff also:

- Interviewed the Vice Chairman of Risk Management and Professional Practices and the Global Director of Assurance Quality Control to determine how the firm incorporates and communicates changes in its audit policies, procedures and methodologies;
- Evaluated the effectiveness of the design of the processes for monitoring developments that might require additions to or changes in the firm's audit policies, procedures and methodologies; and
- Evaluated the nature and content of five recent additions to, or changes in, the firm's audit policies.

g. Review of Policies Related to Foreign Affiliates

The staff performed procedures in this area in order to begin forming a basis on which to evaluate the processes the firm uses to ensure that the audit work performed by its foreign affiliates on the foreign operations of U.S. clients is reliable and in accordance with the standards established by the Board. The staff did not inspect the audit work of foreign affiliates; rather, the inspection procedures with respect to such work were limited to the supervision and control, in accordance with standards established by the Board, exercised by the U.S. firm over such work.

The staff read, reviewed and analyzed the following information at the national office:

- Policies and procedures related to the U.S. firm's supervision and control of work performed by the U.S. firm's foreign affiliates on the foreign operations of U.S. issuer clients, including those related to:
 - How the firm ascertains the professional reputation of the affiliated firm;

- Procedures the U.S. firm employs to obtain reasonable assurance that the foreign affiliates and their personnel comply with the SEC's independence requirements;
- Procedures the U.S. firm employs to obtain reasonable assurance that personnel of the affiliated firm responsible for performing the work on the foreign operations of the U.S. issuer clients are familiar with U.S. GAAP, PCAOB standards, SEC independence rules, and relevant SEC financial reporting requirements; and
- Procedures the U.S. firm employs to obtain reasonable assurance that foreign affiliates and their personnel understand and comply with relevant audit policies and procedures of the U.S. firm;
- Audit guidance related to planning and administering global or multi-location engagements;
- A summary of the results of the most recent foreign affiliated firms' internal inspection;
- Evidence related to whether professional employees in foreign affiliated firms assigned to U.S. issuer clients have sufficient familiarity with U.S. GAAP and PCAOB standards, independence rules, relevant financial reporting requirements, and the applicable policies of the U.S. firm, including:
 - Information databases and tools;
 - An international practice manual; and;
 - Documentation describing the involvement of the E&Y Capital Markets Accounting and Auditing Centers in giving assistance to U.S. multinational engagement teams with respect to U.S. GAAP, PCAOB standards, related SEC accounting questions and engagement execution;
- The firm's global international independence policy; and
- The joining agreement documents by which foreign affiliated firms agree to become members of E&Y Global.

The staff also interviewed those responsible for oversight of the work performed by foreign affiliates on foreign operations of U.S. issuer clients. The staff interviewed the partner responsible for the foreign affiliates' internal inspection program; the partner responsible for international training, the partner responsible for compliance with the independence rules on a global basis, and a partner from the Capital Markets Accounting and Auditing Center – London. Finally, the staff's procedures at the four practice offices included inspecting two audit engagement teams' supervision and control procedures over the audit work performed by the firm's foreign affiliates on the foreign operations of the U.S. issuers.

B. Observations Concerning Audit Performance

As part of the 2003 limited inspection of E&Y, the staff reviewed certain portions of 16 audit engagements. The selected engagements generally involved audits of issuers for fiscal years ended in 2002. In addition, the staff's review of E&Y's internal inspection program involved or resulted in the staff reviewing aspects of 10 additional engagements. The staff also requested that E&Y review the compliance by seven other issuers with the provisions of Emerging Issues Task Force No. 95-22 ("EITF 95-22"), *Balance Sheet Classification of Borrowings Outstanding under Revolving Credit Agreements That Include both a Subjective Acceleration Clause and a Lock-Box Arrangement*.^{6/} Based upon a review of relevant documents filed with the SEC, the staff had concluded that the financial statements of three of these issuers appeared not to conform to the provisions of EITF 95-22.

This section describes, at a general level, certain deficiencies in E&Y's audit performance as observed in this review of audit engagements. In some of the engagements reviewed, the staff identified errors in the application of GAAP that E&Y had either not identified or not appropriately addressed during the audit. Specifically, the staff's prompting of E&Y to review the potential misapplication of EITF 95-22 led to identification of seven engagements in which that GAAP error occurred, resulting in restatement in three of those cases. In addition, some of the audit engagements reviewed were found to involve some degree of departure from PCAOB standards or E&Y's own quality control policies or both.

^{6/} The Board's staff made this same request concerning EITF 95-22 to each of the four firms inspected by the Board in 2003.

1. Failure to Identify or Address GAAP Exceptions

a. *Staff Discoveries Resulting in Restatements by Issuers*

Three E&Y clients have restated their balance sheets to address GAAP exceptions as a result of the staff bringing the EITF 95-22 issue to E&Y's attention. The provisions of EITF 95-22 require that balances under revolving lines of credit must be classified as current liabilities of the borrower if the loan agreements contain both a subjective acceleration clause and a requirement to maintain a lock-box arrangement for customer remittances whereby remittances from the borrower's customers immediately reduce the outstanding obligation. E&Y had failed to identify that the three issuers in question had incorrectly classified such debt as a long-term liability. The effect of this misclassification was to understate current liabilities and, thereby, to overstate working capital. In each case, E&Y agreed with the staff's view, and the issuers restated certain financial statements to classify the debt as a current liability. Two of these issuers restated previously audited balance sheets, and one restated unaudited but reviewed balance sheets for two quarters.

b. *Other GAAP Exceptions*

In addition to the three engagements discussed in section a above, the staff identified four other instances involving the misapplication of EITF 95-22 where the issuer had incorrectly classified as a long-term liability the balance on a revolving credit facility that included a subjective acceleration clause and a lock-box arrangement.

E&Y informed the staff that it has concluded that these other four issuers had improperly classified obligations under revolving lines of credit as long-term in nature, but that restatements of the most recent years' financial statements were not necessary. E&Y has informed the staff that it did not consider the misclassifications to be material for three of these issuers.^{7/} In one of these instances, however, the issuer subsequently elected to properly classify the balances of the debt in financial statements for a prior period. One of these issuers has obtained a formal amendment to the loan agreement, which it believes allows for prospective non-current classification of the debt.

^{7/} Even if immaterial to current financial statements, some GAAP errors present the potential to be material to future financial statements if the accounting is not corrected.

2. Departures from PCAOB Standards and from E&Y's Own Quality Control Policies

a. *Staff Discoveries That Led to Additional Procedures by E&Y*

In the following cases where the staff identified departures from PCAOB standards, E&Y performed additional audit procedures as a result of the staff identifying deficiencies.

(1) With respect to the audit of one issuer, the staff identified several deficiencies in the engagement team's application of PCAOB standards. Those deficiencies are summarized below. These deficiencies appeared to the staff to be potentially material, and the staff asked E&Y to evaluate and correct the deficiencies in order to determine whether there had been an undetected material misstatement of the issuer's financial statements. In documentation prepared in response to the issues noted by the staff, E&Y agreed that there had been material deficiencies in the audit. As to each of the deficiencies identified by the staff, E&Y responded by performing additional procedures and/or supplementing the documentation in the work papers such that, ultimately, the staff concluded that sufficient additional work had been performed to correct the deficiencies. Those deficiencies included the following –

- The E&Y engagement team placed significant reliance on the work of the internal audit department of the issuer (with respect to testing of accounts receivable, account reconciliations, revenue, disbursements, payroll, capital expenditures and accrued liabilities) without having obtained sufficient evidence of the competency and objectivity of the internal audit function and without conducting sufficient evaluation and testing of the effectiveness of the internal audit function, and thus failed to comply with Professional Standards AU Section 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* ("AU Section 322"). In addition, to the extent that the engagement team performed an assessment of the competency and objectivity of the internal audit function, the engagement team failed to document that assessment adequately.
- The engagement team did not confirm accounts receivable due to assertions that there was low inherent risk and that there was minimum control risk. The engagement team viewed its assessment of minimum control risk as supported by the results of the internal audit work. Because of the issue described above concerning reliance on internal control work, and because of the

lack of documentation to support the engagement team's conclusions of low inherent risk and minimum control risk, the staff viewed the audit work performed as insufficient.

- The engagement team failed to include in the summary of audit differences ("SAD"),^{8/} and failed to report to the audit committee, the fact that a portion of the issuer's recorded tax reserve was not allocated to a specific obligation and therefore not in accordance with GAAP.
- The engagement team failed to conduct adequate levels of testing of additions to the balance of certain capitalized costs. In addition, the work papers failed to include documentation of the engagement team's understanding of the evidential support for the particular cost or of the controls and processes in place to determine whether the expenditure is properly capitalizable.
- The work papers did not contain a copy of certain data provided to the engagement team by E&Y's environmental specialists, who had been used to analyze certain issues, nor did they provide evidence of the disposition of matters raised by the specialists. The work papers also did not document the engagement team's consideration of the audit impact of E&Y's technology specialists' finding of certain internal control weaknesses.
- The work papers did not include sufficient evidential matter to indicate that the engagement team had performed sufficient testing to insure that all information was captured accurately and completely in the issuer's conversion to a new general ledger system.
- The issuer paid a certain amount to extinguish a lease obligation and acquire the previously leased property, then recorded the value of the asset as the amount paid to extinguish the lease obligation.

^{8/} In the course of performing the audit, E&Y auditors accumulate variances above a nominal amount (which is set as part of audit planning) between the issuer's recorded balances and the balances the auditors believe is more accurate. These variances can be either known variances or differences in estimates. The variances are recorded on a summary of audit differences ("SAD") and are evaluated in relation to the materiality level of relevant financial statement components.

The work papers did not contain any analysis of whether the capitalized amount exceeded the fair value of the assets.

- In several other significant respects, the work papers did not include documentation from which it could be discerned whether the engagement team had performed testing, analyses, and evaluations.

(2) On one engagement, the staff noted that a signed management representation letter was not in the audit work papers and, although the engagement team stated that the letter had been received, none could be located at the time of the staff's review. During the summer of 2003, this engagement was subject to review by E&Y's internal inspection program, known as AQR. The engagement team represented that the management representation letter was included in the audit work papers during the AQR, but was misplaced between the time of the AQR and the staff's inspection. The engagement team contacted the issuer's management and obtained another signed representation letter dated as of the audit report date.

(3) On one engagement, the staff noted that the audit work papers related to the accrual for income taxes contained no documentation or indication that any audit work was performed on the following balances: provision for income taxes; deferred tax assets (including deferred tax credit carryforwards classified as current deferred tax assets); income taxes payable; and deferred tax liabilities. The engagement team indicated that it had reviewed a schedule showing the components of the reserve; in response to the staff's comments, it contacted the issuer's management and obtained schedules detailing the issuer's income tax exposure items. The engagement team supplemented the audit work papers with an overall tax review memorandum which summarized the audit procedures performed. For the deferred tax credit carryforwards classified as current assets, the engagement team prepared a memorandum supporting the current classification of the deferred tax asset based upon 2003 income projections. In addition, the engagement team documented the significant income tax exposures of the issuer, analyzed the likelihood and amount of exposure for each item, and concluded on the appropriateness of the reserve. The engagement team also documented the tracing of amounts to supporting documentation and the mathematical accuracy of the schedules.

(4) In one case, the tax accrual work papers included no work papers to support a tax exposure liability. Upon request, the staff was provided with the issuer's schedule, which had been retained in the E&Y tax partner's files. The tax partner also verbally explained the more significant items on the schedule to the staff. To answer the staff's questions about certain items on the schedule,

the audit and tax partners contacted the issuer and discussed the propriety of these items. As a result of the engagement team's discussion with the issuer, certain exposure items on the schedule were identified as overstated. These procedures also identified additional tax exposures not represented on the schedule that, nevertheless, the issuer asserted had existed at the balance sheet date. The engagement team determined that no change to the financial statements was warranted, due to the immateriality of the amount. The engagement tax partner documented these issues in a supplemental memorandum which was added to the audit work papers.

(5) On one engagement, the staff noted that management representation letters from two of the issuer's subsidiaries lacked certain signatures required by AU Section 333, although they were each signed by one or more appropriate members of management. Although an appropriate letter of representation from management of the parent had been obtained, separate representation letters were required for each of the two subsidiaries, as E&Y issued separate opinions for each subsidiary. The engagement team agreed with the finding and obtained the appropriate signatures from the issuer's management on the management representation letters.

(6) The staff noted that one issuer was a limited partner in a real estate limited partnership, of which the general partner was an officer and member of the Board of Directors of the issuer. The investment in the real estate limited partnership constituted less than one percent of the issuer's consolidated total assets and 2.6 percent of its consolidated net income. The audit work papers did not contain evidence that the engagement team obtained the most recent financial statements of the limited partnership. These were needed to determine its appropriate share of income and that the investment account reconciled to the capital accounts of the limited partnership as of December 31, 2002. As a result of the staff's comments, the engagement team obtained a copy of the unaudited balance sheet from the partnership accountant. The engagement team multiplied the amount reported as Partners' Equity on the balance sheet by the issuer's ownership percentage and agreed the amount to the amount recorded by the issuer without material exception. The engagement team added this additional documentation to the work papers and dated the document currently.

b. Additional Departures From E&Y's Policies, Other than Documentation Deficiencies

The staff identified other departures from the firm's own quality control policies that involved deficiencies other than documentation deficiencies. Specifically, on five engagements, work papers were not archived within the time period required by E&Y policy.

c. Additional Departures Concerning Documentation

The staff noted additional documentation deficiencies in the engagements reviewed. With respect to these deficiencies, the staff concluded either that other evidence allowed the staff to reach the same conclusions that the engagement team had articulated, or that, despite a lack of other evidence, those deficiencies did not render the audit as a whole deficient.^{9/}

(1) Ten engagements reviewed were missing various senior engagement team sign-offs, or were not signed-off in a timely manner. The staff's findings relating to sign-offs varied from sign-offs on key work papers dated subsequent to the issuance of the audit opinion to missing sign-offs for preparers or reviewers. In all cases, the staff was able to review other written evidence, such as dating of electronic work papers, copies of audit committee presentations where the auditors presented the significant issues from the audit, if any, or minutes from closing meetings with the issuer's management, that corroborated the participation of senior engagement team members in the final steps of the audit process.

(2) Nine of the engagements reviewed had insufficient audit documentation for subjective accounting estimates and reserves. For eight of these engagements, the staff ascertained that an appropriate level of audit testing had been performed, but had not been documented in the work papers. Remedial actions were taken by the engagement team on these eight engagements, which principally consisted of supplementing the audit work papers with additional supporting documentation as to the work performed and/or conclusions reached by the engagement team. As to the ninth engagement, the staff's efforts continue.

(3) In addition to the instance described in section I.B.2.a(1) above, the staff identified two other engagements in which the engagement team did not adequately document the use or competency of, or degree of reliance on, the internal auditors. The work papers for one engagement did not document the scope of testing performed by internal audit, the review and re-testing of the internal audit function's work in certain areas, and the engagement team's assessment of the competency and objectivity of the internal auditors. The work papers for the other audit did not document the scope of the internal audit group's work. In both cases, the staff's observations resulted in the engagement

^{9/} The staff reached that conclusion based on consideration of the inherent risk of misstatement and the materiality of the financial statement component at issue, combined with the extent and nature of other related internal control and substantive audit procedures carried out.

teams supplementing the audit work papers with additional supporting documentation as to the work performed and/or conclusions reached by the engagement team.

(4) On three engagements, the engagement teams did not adequately document the basis for reliance on specialists in executing the audit. On one of these engagements, an internal valuation specialist was used to evaluate the reasonableness of the underlying assumptions for the discounted cash flow analysis. The specialist also evaluated the reasonableness of the addition of a "control premium" in determining the fair value of the issuer for a goodwill impairment analysis. While the work papers documented that a specialist had been used and that the specialist concurred with the issuer's calculation, there was insufficient documentation in the work papers of the detailed considerations supporting the specialist's conclusions. In response to the staff's observation, the engagement team prepared a supplemental memorandum which documented the considerations of the engagement team and specialist regarding the involvement of the internal valuation specialist, as well as the methodology and assumptions used by the specialist.

On another engagement, the work of an external actuarial specialist was used in determining the reasonableness of a self-insurance reserve. The work papers insufficiently documented the testing performed on the data and information provided by the issuer and used by the actuarial specialist in calculating an estimate of the self-insurance reserve. In response to the staff's observation, the engagement team supplemented the existing work papers to document its analyses of the data, including year-over-year analyses of the current and prior year's data, and to document information used by the actuarial specialist.

On a third engagement, the engagement team relied upon the work of an independent monitor for bankruptcy proceedings, but did not document the basis for such reliance. Additionally, the engagement team did not adequately test the data and information provided by the issuer and used by an actuarial specialist in calculating an estimate of a self-insurance reserve. To remedy these deficiencies, the engagement team stated that it would document the basis for reliance on the independent monitor and also stated that it would test the 2002 actuarial data in conjunction with the 2003 audit.

(5) In addition to the engagements discussed at sections I.B.2.a(3) and I.B.2.a(4) above, five other engagements reviewed had deficiencies in documentation of audit procedures relating to the recorded income tax expense and related tax assets and liabilities recorded on the balance sheet. In general, the deficiencies noted by the staff related to the lack of documentation of audit

work that had been performed. Specifically, the individual findings were that tax schedules and/or footnotes were not traced to supporting documentation, documentation did not exist to evaluate tax exposure reserves or valuation allowances, sufficient testing of the income tax provision and balance sheet accounts relating to income taxes was not documented, and assessments of the income tax rates used were not supported in the work papers. In each case, remedial actions were undertaken by the engagement team which principally consisted of supplementing the audit work papers with additional supporting documentation as to the work performed and/or conclusions reached by the engagement team.

C. Certain Board Observations

As intended, the 2003 limited inspection of E&Y has provided an important foundation for more far-reaching inspections of the firm. Within the seven functional areas, the Board has identified issues that will warrant more probing scrutiny in a full-scale inspection, and examination of these issues will continue in annual inspections of E&Y. These issues, however, do not lend themselves to a thorough critique on the basis of a single, limited inspection.

As a general matter, the Board is encouraged by indications that the mere anticipation of a review of the firm's practices may already have had a positive effect on the firm, as the staff found a number of recent changes to firm policies and procedures relating to some of the seven functional areas. The Board is also encouraged by indications that the firm understands that the Act calls for a renewed and heightened focus on audit quality. In addition, the firm was cooperative and responsive with respect to questions raised by the staff about compliance with auditing standards and accounting principles.

Even so, the Board intends to maintain a critical eye, through the inspection process, on the development of the firm's initiatives, and their impact on audit quality, over time. The limited inspection has revealed issues that Board inspectors will probe more deeply in future inspections and that the Board will expect the firm to address as the Board refines its understanding of the firm's practices.

END OF PART I

**PART II OF THIS REPORT IS NONPUBLIC
AND IS OMITTED FROM THIS PUBLIC DOCUMENT**

PART III

RESPONSE OF E&Y TO DRAFT INSPECTION REPORT

Pursuant to section 104(f) of the Act 15 U.S.C. § 7214(f), and PCAOB Rule 4007(a), the Board provided E&Y an opportunity to review and comment on a draft of this report. E&Y provided a written response.

Pursuant to section 104(f) of the Act and PCAOB Rule 4007(b), if a firm requests, and the Board grants, confidential treatment for any of the firm's comments on a draft report, the Board does not include those comments in the final report. The Board routinely grants confidential treatment, if requested, for any of a firm's comments that the firm reasonably believes are mooted by a change made to the report before the Board finalizes the report.

Pursuant to section 104(f) of the Act and PCAOB Rule 4007(b), the firm's response, minus any portion granted confidential treatment, is attached hereto and made part of this final inspection report. In any version of this report that the Board makes publicly available, any portions of the firm's response that address nonpublic portions of the report are omitted.



Ernst & Young LLP
5 Times Square
New York, New York 10036

Phone: (212) 773-3000
www.ey.com

July 22, 2004

Mr. George Diacont
Director
Division of Registration and Inspections
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, D.C. 20006-2803

Response to Report on 2003 Limited Inspection of Ernst & Young LLP

Dear Mr. Diacont:

We are pleased to provide our response to the Public Company Accounting Oversight Board (“PCAOB” or the “Board”) regarding its report (the “Report”) on the 2003 limited inspection of Ernst & Young LLP (“E&Y”). The inspection process is a fundamental component of the PCAOB’s mission.

As the independent auditor of more than 2,500 public companies in the United States, our overriding objective is to make certain that all aspects of our auditing and quality control processes are of high quality. This focus on quality both serves the public interest and benefits our firm. The PCAOB’s limited inspection during 2003 assisted us in identifying areas where we can continue to improve our performance. We have taken or will be taking steps to address all of the matters described in the Report. We are confident that future inspections will continue to enhance our audit quality and strengthen the accounting profession.

We have summarized below our response to Part I of the Report, primarily to provide our views on particular findings and to add context to the reported findings. In addition, we have provided more detailed comments in response to Part I of the Report in an attachment to this letter and request that you consider them in preparing your final report on the 2003 limited inspection.

Accounting Issue

The one accounting issue described in the Report related to the presentation of certain debt agreements. The Report describes three restatements and four other presentation errors not requiring restatement as a result of the provisions of EITF 95-22 not being applied properly to certain debt agreements and our audit procedures not detecting these misclassifications. Although we agree with the findings in the Report, we are providing additional detail and context

to enable a reader of the Report, with no knowledge of these engagements or the issues, to better understand them.

During inspection procedures at another auditing firm, the PCAOB staff discovered one or more engagements where the requirements of EITF 95-22 were not appropriately applied. This led the staff to search public databases that included the more than 2,500 E&Y SEC audit clients and identify companies with characteristics that would raise the possibility of EITF 95-22 not being applied properly in their financial statements. The staff's identification of these situations was not the result of their reviews of a sample of audit engagements.

After investigating each of the situations identified by the PCAOB staff, in two situations the issuer and E&Y concluded that the debt needed to be reclassified from long term to current liabilities in previously audited financial statements. In one other situation, the debt agreement was entered into subsequent to our last audit and the issuer reclassified the debt in its unaudited quarterly financial statements (although the issuer's original unaudited balance sheet was reclassified, no audit opinion had been rendered on such unaudited quarterly financial information). In the other situations, the issuer and E&Y concluded that no financial statements needed to be reissued to reflect such reclassifications due to the immateriality of the effects of such reclassifications or other factors.

As a result of this matter, we issued an alert to our partners and staff to reemphasize our firm's guidance regarding EITF 95-22, specifying that they particularly review debt agreements during our 2003 audits, and requiring consultation whenever the applicable conditions were present.

Auditing Issues

The PCAOB thoroughly reviewed the audit engagements selected for inspection and appropriately applied very high standards during the inspection of them. As a result of the procedures performed, the PCAOB concluded that five of the audit engagements inspected by the staff had departures from PCAOB standards and that as a result we needed to perform additional audit procedures to support our audit opinions.

We acknowledge the six findings reported by the PCAOB (one engagement had two findings) and we agree that they are accurately described in the Report. Because these are summary descriptions, we believe that, in certain situations, additional detail would be helpful to clarify the underlying facts and circumstances. We agree that one of the engagements had deficiencies that represented a material departure from PCAOB standards and E&Y's quality control policies. We also agree that three of the engagements had deficiencies, although we would characterize them as documentation deficiencies (a category used in the Report to reflect other situations where documentation of auditing procedures or results could have been improved) rather than performance deficiencies. In one situation we do not believe that the issue described by the PCAOB constituted a deficiency in the performance or documentation of the audit.

The PCAOB identified and reported on several documentation deficiencies. We generally agree with the PCAOB's findings in this area, although there is a reference to an open matter that we were not aware of. We have asked the staff for further explanation of this matter. We note that the PCAOB inspection staff applied a rigorous approach in evaluating audit documentation, and subsequently the PCAOB has developed an auditing standard on audit documentation that reflects the rigor demonstrated in the inspection process. We are working hard to make improvements in our audit documentation on a consistent basis across our public company auditing practice.

We are respectful of the PCAOB's inspection process and understand that judgments are involved. During the limited inspection process we made every effort to cooperate with the inspection staff by performing additional procedures or preparing additional documentation to satisfy their requests. However, in most instances we concluded that these additional actions were not needed to comply with PCAOB standards. We are committed to continuously improving the quality of our public company audits and accepted the PCAOB's observations with that spirit in mind.

The Report also mentions certain situations where we did not comply with our internal policies for the archiving of work papers. The process of archiving electronic work papers refers to the procedures we perform at the end of an engagement when our audit procedures and documentation are complete. Electronic work papers are archived to prepare them for electronic storage. Likewise, hard copy work papers are inventoried in the firm's storage system. In the situations described by the PCAOB, the engagements were not processed for storage in a timely manner. We are taking steps to improve the timeliness of our filing procedures.

We appreciate the opportunity to provide our response to the Report and would welcome discussion of any matters that require further explanation before you finalize the Report. We also look forward to working with the Board on other matters of interest to the Board related to our public company auditing practice.

Respectfully submitted,

Ernst + Young LLP

Attachment

Attachment to E&Y Response – Detailed Comments on Part I

Section B. 1.: Although we agree with the findings regarding EITF 95-22, we would appreciate the PCAOB adding more context to these findings in the Report. We are concerned that a reader of the Report, with no knowledge of these engagements or the issues involved, would not understand the context of the EITF 95-22 issues and might mistakenly believe that the seven instances mentioned in the Report were detected during the PCAOB’s inspection of the sample of audit engagements reviewed rather than through a separate search of information in public databases.

During the inspection procedures at another auditing firm, the PCAOB staff identified one or more engagements where the requirements of EITF 95-22 were not appropriately applied. This led the staff to search public databases that included E&Y’s more than 2,500 SEC audit clients and identify companies with characteristics that would raise the possibility of EITF 95-22 not being applied properly in their financial statements. The PCAOB staff’s identification of these possible situations was not the result of inspections of particular engagements.

After investigating each of the potential situations identified by the PCAOB staff, in two situations the issuer and E&Y concluded that the debt needed to be reclassified from long term to current liabilities in previously audited financial statements. In one other situation, the debt agreement was entered into subsequent to our last audit and the issuer reclassified the debt in its unaudited quarterly financial statements (although the issuer’s original unaudited balance sheet was reclassified, no audit opinion had been rendered on such unaudited quarterly financial information). In the other four situations, the issuer and E&Y concluded that no financial statements needed to be reissued to reflect such reclassifications due to the immateriality of the effects of such reclassifications or other factors.

Therefore, please consider revising your comments to place the EITF 95-22 issues in the context of PCAOB searches of public databases including our more than 2,500 SEC audit clients. Also, after being apprised of this matter by the PCAOB, we issued an alert to our partners and staff to reemphasize our firm’s guidance regarding EITF 95-22, specifying that they particularly review debt agreements during our 2003 audits, and requiring consultation whenever the applicable conditions were present. Please consider adding a description of these actions taken in response to your findings in the Report.

Section B. 2. a.: As stated in the Report, the purpose of this section is to describe those cases where “the staff identified departures from PCAOB standards” and those where “E&Y performed additional audit procedures as a result of the staff identifying deficiencies.” Our comments regarding each of the cases described in the Report are set forth below:

Section B. 2. a. (1) – We agree with the description of the facts as presented and the conclusion that this engagement had departures from PCAOB standards and from E&Y’s quality control policies.

Section B. 2. a. (2) – We agree with the description of the facts as presented. However, we do not agree with the conclusion that this matter represents a departure from PCAOB standards or E&Y’s quality control policies.

Work papers occasionally are lost or misplaced. Our work papers did include a draft of the letter that had been approved by the engagement team for signature by management of the client. As indicated in the Report, “during the summer of 2003 the engagement was subject to review by E&Y’s internal inspection program. The engagement team represented that the management representation letter was included in the audit work papers during the AQR, but was misplaced between the time of the AQR and the staff’s inspection.” When the letter could not be located during the PCAOB’s inspection, we decided to contact the client’s management and obtain a new letter, consistent with the draft letter, dated as of the audit report date. The purpose of obtaining the new letter was to replace the one that we believe existed at the time our report on the issuer’s financial statements was issued.

Please consider removing this engagement from Section B. 2. of the Report. An alternative would be to include the matter in Section B. 2. c. (5) where documentation deficiencies are described. We do not believe this misplacement of the representation letter warrants singling out the audit engagement as one where E&Y failed to comply with PCAOB standards or our quality control policies.

Section B. 2. a. (3) – We agree with the description of the facts as presented. However, we believe additional significant facts should be included in the description of this matter. In addition, we do not believe this matter represents a departure from PCAOB standards or from E&Y’s quality control policies, other than E&Y’s policies pertaining to documentation.

We agree that the audit work papers did not include appropriate documentation of the audit procedures performed for the income tax account balances. However, we believe that appropriate procedures were performed at the time of the audit. Tax professionals assisted the audit team with the procedures relating to income taxes and they were knowledgeable of the composition of the account balances and judgmental issues pertaining to them. Time records were produced to the PCAOB staff that indicated significant hours spent by the tax professionals at the time of the audit. Further, the E&Y tax professionals had documented their review of key schedules at the time of the audit. However, these schedules were maintained by the client and not copied for our work papers.

Please consider reclassifying this engagement from Section B. 2. a. of the Report to Section B. 2. c. (5) where documentation deficiencies are described.

Section B. 2. a. (4) – Although we agree that this matter constitutes a documentation deficiency, we do not believe this matter represents a departure from PCAOB standards or from E&Y’s quality control policies, other than E&Y’s policies pertaining to documentation.

We agree that the audit work papers did not include appropriate documentation of our assessment of the tax exposure liability and that the tax partner, who had primary responsibility for our audit procedures on the client's recorded amount, did not document all of his considerations and conclusions regarding the items that comprised the balance. As noted in the PCAOB's description of this matter, some audit documentation was maintained in the tax partner's files rather than in the audit work papers. Our tax partner discussed these issues during the engagement team's meeting with the PCAOB staff at the outset of the engagement review. Although we did improve our documentation in response to the PCAOB's inquiries, we did not change our assessment of the recorded amounts that we made at the time of the audit.

Please consider reclassifying this engagement from Section B. 2. a. of the Report to Section B. 2. c. (5) where documentation deficiencies are described.

Section B. 2. a. (5) – We agree with the description of the facts as presented and the conclusion that this engagement had departures from a PCAOB standard.

Section B. 2. a. (6) – We agree with the description of the facts as presented but believe that additional significant facts also should be presented. In addition, we do not agree with the conclusion that this matter represents a departure from PCAOB standards or from E&Y's quality control policies.

The issuer's recorded investment in the real estate limited partnership represented less than one percent of total assets and less than three percent of net income before taxes. The partnership has owned a single piece of real estate for over fifteen years that is leased to a major city. The engagement team performed interim audit procedures on the recorded balances as documented in the work papers but did not perform any additional procedures at year end because of (1) the insignificance of the recorded amount in relation to the issuer's financial statements taken as a whole and (2) the engagement team's knowledge of the underlying investment of the partnership. We agreed to perform the additional procedure described in the Report at the PCAOB staff's request, but not because we believed it was necessary to support our opinion on the financial statements.

Please consider removing this engagement from Section B. 2. of the Report. We do not believe that the engagement team's decision to test the account balance at an interim date rather than at year end constituted a failure to comply with either PCAOB standards or E&Y's quality control policies.

Alternatively, please consider revising the description of the matter to indicate that audit procedures were performed on interim balances because of the insignificance of the recorded investment to the issuer's financial statements taken as a whole and the engagement team's knowledge of the underlying investment of the partnership.

Section B. 2. b.: The archiving process is set forth in E&Y's quality control policies and is not part of the PCAOB's standards. Therefore, in our opinion, most readers of the Report will not

understand the description of this matter without further explanation. Please consider describing the process of archiving more completely so that a reader will fully understand the matters being described. Consider using the following description: “The process of archiving electronic work papers refers to the procedures E&Y performs at the end of an engagement when their audit procedures and documentation are complete. Electronic work papers are archived to prepare them for electronic storage. Likewise, hard copy work papers are inventoried in the firm’s storage system. In the situations described above, the engagements were not processed for storage in a timely manner.”

Section B. 2. c.: Generally we agree with the description of the facts as presented; however, Section B. 2. c. (2) of the Report states “As to the ninth engagement, the staff’s efforts continue.” We were unaware that the staff had open issues regarding this engagement and request that the PCAOB staff communicate the open issues to us so that we are able to respond.